

OFFICE OF THE GENERAL COUNSEL

MEMORANDUM GC 00-07

September 22, 2000

TO: All Regional Directors, Officers-in-Charge and Resident Officers**FROM:** Leonard R. Page, General Counsel**SUBJECT:** Reimbursement for Excess Federal and State Income Taxes which Discriminatees Owe as a Result of Receiving a Lump-sum Backpay Award

This memorandum sets forth guidance as to the proper remedy Regions should seek in all pending and future cases in which a discriminatee would owe excess federal and state income taxes as a result of receiving a lump-sum backpay award.

Under current tax laws, discriminatees who receive lump-sum backpay awards covering a multi-year backpay period are likely to incur higher federal and state income taxes than they would have had they received their wages in due course. This is because the Internal Revenue Service (IRS) considers back pay awards to be taxable income¹ earned in the year *the award is paid*, rather than over the previous years in which a discriminatee would have earned the wages but for the unlawful discrimination.² Until 1986, federal regulations, as well as many state tax codes, incorporated income averaging for large year-to-year differences in earned income, including lump-sum backpay awards. By effectively spreading income over the period of time the award was meant to compensate, the income averaging provision more evenly distributed taxable income and drove down a discriminatee's total tax liability. In 1986, however, Congress repealed the income averaging provision, and many states have since followed suit.³

Thus, a lump-sum backpay award is likely to move discriminatees into a higher tax bracket, significantly impairing the Board's ability to reinstate the *status quo ante* without a mechanism to compensate discriminatees for the extra taxes. Accordingly, in any pending or future case Regions should seek a "tax component" to a backpay award obligating respondents to reimburse discriminatees for extra federal and state income taxes that would result from a lump-sum backpay award.

The Board last addressed the propriety of a tax component to a backpay award in the mid 1980s in *Hendrickson Bros., Inc.*⁴ and *Laborers Local 282 (Austin Co.)*.⁵ In both these cases, the Board rejected proposed tax components solely because the discriminatees could avail themselves of the then-extant income averaging provision.⁶ Thus, the Board has not had occasion to address the propriety of a tax component since the repeal of income averaging.

The Board's authority to reinstate the *status quo ante* derives from its broad Congressional mandate under Section 10(c) of the Act to determine the proper scope of its remedial orders, particularly with respect to affirmative relief.⁷ This wide discretion is unnecessary insofar as Congress, in enacting the National Labor Relations Act, could not "define the whole gamut of remedies to effectuate these [statutory] policies in an infinite variety of specific situations."⁸ Thus, by its plain meaning, Section 10(c) is a grant of authority to the Board to devise remedies for various unfair labor practices, so long as such remedies "effectuate the policies of the Act."⁹

In addition, other administrative agencies, as well as the federal courts, have incorporated tax components into remedial schemes under other employment statutes. For instance, in *Sears v. Atchison, Topeka & Santa Fe Railway Co.*,¹⁰ the Tenth Circuit held that a tax component to a 17-year, lump-sum backpay award in a racial discrimination lawsuit under Title VII was an appropriate exercise of the trial court's "wide discretion in fashioning remedies to make victims of discrimination whole."¹¹ Among the "special circumstances" which favored a tax component were the protracted nature of the litigation and the ineligibility of the estates of the deceased discriminatees (of whom there were many) to take advantage of the then-extant income averaging provisions of the IRS tax code.¹²

More recently, in *O'Neill v. Sears, Roebuck and Company*, the district court appended a tax component to a lump-sum backpay

award in order to satisfy the "make-whole purpose governing remedies for employment discrimination cases arising under the [Age Discrimination in Employment Act]".¹³ The court noted that the discriminatee would have earned the backpay had the employer not unlawfully terminated him.

Therefore, he is entitled to receive the value of front pay and backpay that he would have received over his worklife. That value is diminished when the lump sum is taxed at a higher level.¹⁴

The Equal Employment Opportunity Commission has similarly sought tax components to backpay awards both in federal district court (e.g., *EEOC v. Joe's Stone Crabs, supra*) and in its own administrative hearings. In *Kalra v. Pena*, the Commission remanded a request for a tax component to an EEOC ALJ for a determination of the amount of the "pecuniary losses incurred as a result of the increased tax burden of a lump-sum backpay award made as a result of the admitted discrimination."¹⁵ The Commission's reimbursement order further comports with the EEOC's "prevailing practice in the settlement of Title VII suits which commonly include an amount to offset the plaintiff/taxpayer's increased tax liability."¹⁶

Accordingly, to fully effectuate the Act's goals, Regions should seek a tax component in all pending and future cases to reimburse discriminatees for the excess federal and state income taxes they would owe from receiving a lump-sum backpay award covering more than one year of backpay. Such a tax component should reimburse discriminatees only for their *increased* tax liability, equal to the *difference* in taxes discriminatees would owe upon receipt of a lump-sum payment and the taxes they would have owed had they not been unlawfully terminated. Further, in order to notice parties of this change in position, tax components should be specifically pled in the complaint and/or backpay specification.¹⁷ As with any backpay remedy, however, Regions have the discretion to settle a case for less than the full backpay owing.

Cases which present issues not resolved by this memorandum should be submitted to the Division of Advice.

/s/
Leonard R. Page
General Counsel

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¹ See I.R.S. Revenue Ruling ("Rev. Rul.") 75-64, 1975-1 C.B. 16 (1975) (backpay awards are wages for the purposes of the Federal Insurance Contribution Act, the Federal Unemployment Tax Act and the Collection of Income Tax at Source on Wages).

² IRS Rev. Rul. 78-336, 1978-2 C.B. 255 (1978). See also "Reporting Back Pay and Special Wage Payments to the Social Security Administration," SSA Publication 957 (Rev. September 1997), p.2 ("The Internal Revenue Service (IRS) and the [Social Security Administration] consider back pay awards to be wages. However, for income tax purposes, the IRS treats all back pay as wages in the year paid.") (Emphasis in original.)

³ California, for instance, has similarly repealed income averaging. Bills to reinstate income averaging for recipients of backpay and frontpay awards have been introduced before both the House and Senate, without subsequent action to date. See Civil Rights Tax Fairness Act of 2000, S. 2887, 106th Cong., 146 Cong.Rec. S7162-64 (2000); Civil Rights Tax Fairness Act of 1999, H.R. 1997, 106th Cong., 145 Cong.Rec. H3710 (1999).

⁴ 272 NLRB 438 (1985), enf'd 762 F.2d 990 (2nd Cir. 1985).

⁵ 271 NLRB 878 (1984).

⁶ *Hendrickson*, 272 NLRB at 440; *Austin*, 271 NLRB at 878. In both cases, the Board cited to the predecessor of Sec. 10637.3 of the Board's Caschandling Manual (Part Three - Compliance Proceedings), in which discriminatees are advised to contact the IRS to determine whether income averaging procedures could reduce the tax impact of large backpay awards. Clearly, this

consideration no longer has force in light of Congress' repeal of that part of the tax code.

⁷ See, e.g., *Sure-Tan, Inc. v. NLRB*, 467 U.S. 883, 898-99 (1984) (Congress vested in Board "the primary responsibility and broad discretion to devise remedies that effectuate the policies of the Act, subject only to limited judicial review").

⁸ *Phelps Dodge Corp. v. NLRB*, 313 U.S. 177, 194 (1941).

⁹ *Frontier Hotel & Casino*, 318 NLRB 857, 863 (1995), enf'd in pert. part sub nom. *Unbelievable, Inc. v. NLRB*, 118 F.3d 795 (D.C. Cir. 1997).

¹⁰ 749 F.2d 1451 (1984), cert. den. sub nom. *United Transp. Union v. Sears*, 471 U.S. 1099 (1985).

¹¹ *Id.* at 1456.

¹² These factors are present in many cases arising under the National Labor Relations Act.

¹³ __ F.Supp.2d __, 2000 WL 1133269, *4 (E.D.Pa., July 31, 2000), quoting *Squires v. Bonser*, 54 F.3d 168, 172 n.7 (3d Cir. 1995).

¹⁴ *O'Neill v. Sears*, 2000 WL 1133269, *5. To use the court's colloquialism, "It's not how much you make, it is how much you keep." *Id.* at *4. See also *Gelof v. Papineau*, 648 F.Supp. 912, 930 (D.Del. 1987), remanded 829 F.2d 452 (3d Cir. 1987) (court awarded plaintiff tax component to ADEA backpay award in light of repeal of income averaging provision); *EEOC v. Joe's Stone Crab, Inc.*, 15 F.Supp.2d 1364, 1380 (S.D.Fla. 1998), vac. and remanded 220 F.3d 1263 (11th Cir. 2000) (tax component denied because plaintiff failed to provide sufficient evidentiary foundation to permit court to make calculation).

¹⁵ EEOC Appeal No. 01924002, slip op. at 8 (February 25, 1994). Although the Commission ordered the reimbursement under its authority to award compensatory damages rather than make-whole relief, its equitable concerns mirror those articulated by the court in *Atchison v. Sears, supra*, a make-whole case upon which the *Kalra* Commission relied.

¹⁶ *EEOC v. Joe's Stone Crab*, 15 F.Supp.2d at 1380.

¹⁷ Nonetheless, a traditional make-whole order already pled under an existing complaint or ordered by the Board or an ALJ is sufficiently broad to encompass a tax component. As the court in *O'Neill v. Sears* recognized, a discriminatee subject to a make-whole order is entitled to receive the "value" of the wages he would have received, but for the discrimination. The "value" of a backpay award, without a tax component, severely understates discriminatees' actual damages. Equity, as well as the effectuation of the Act, thus requires compensation for their pecuniary losses.